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SUBJECT: Scene Setter for Deputy Secretary Steinberg

CLASSIFIED BY: Michael McKinley, Ambassador, State, Amb; REASON:
1.4(B), (D)

¶1. (C) Summary: Peru remains a critical "swing state" in a region divided along political fault lines. Peru's remarkable success in turning the page on 30 years of dictatorships, populism, near failed state status, and authoritarianism has given way to a decade of record economic growth, democratic consolidation, and significant poverty alleviation. But there is still a long way to go. The challenges include a still high absolute poverty rate, weak institutions, drug trafficking, residual terrorist activity, and the lure of false populism.

¶2. (C) Your visit comes at an important moment in this continuing transition. Peru has weathered the global economic crisis in impressive shape but is moving into an electoral season that will span the next 18 months. The country will be choosing between consolidating and expanding past gains or possibly veering off into another (Bolivarian) direction. Meantime, the government hopes to resume robust growth and further integrate Peru into the global economy via free trade agreements with China, Japan, the European Union, Canada and others. President Garcia has also sought to strengthen relations with Ecuador, Colombia and Brazil. Garcia is among the most strategic of current Latin American presidents and has been a solid U.S. partner on Honduras, nuclear proliferation, Copenhagen, APEC agendas, and Colombia.

¶3. (C) As in Colombia, there is growing concern here that the U.S. is paying insufficient attention to its partners in South America. Your visit should help correct this perception and underscore the importance we attach to Peru's accomplishments to date. You will also have the opportunity to see first-hand our successes in alternative development, our progress in implementing a ground-breaking free trade agreement with strong environmental and labor commitments, and to review our public affairs outreach to new generations and marginalized populations. End Summary.

¶4. (C) Peru has been and considers itself a solid U.S. partner in a complicated South America that is divided along political and ideological fault lines. In meetings with U.S. visitors, President Garcia has referred to the regional "cold war" at play -- pitting a populist, autocratic bloc openly antagonistic to the U.S. against a democratic, trade and investment-friendly one that prizes its ties with the U.S. In this context, the U.S.-Peru partnership is rooted in a shared vision of opportunities and challenges. For example, the GOP sees enormous benefits associated with Peru's insertion into the international economic system and has actively sought to

deepen its global engagement, including by welcoming foreign investment and signing free trade agreements with the U.S. and a slew of other countries -- from Canada to China, Singapore and the EU. We also see eye to eye regarding the tangible threat of international criminal groups, particularly drug traffickers and the potentially resurgent Sendero Luminoso (Shining Path) terrorist organization, and the growing nexus between the two. Neither has President Garcia hesitated to publicly highlight the dangers of false populism (having succumbed to the temptation during his first term - 1985-90) and the threat of Venezuelan and Bolivian meddling in Peru's internal affairs, including via support for a wide-ranging network of radical groups seeking to undermine the country's progress and change its political-economic model. Even so, Garcia has sought to minimize diplomatic conflict with Bolivia and Venezuela while sometimes responding in kind to public provocations.

¶15. (C) The fruit of a decade plus of pragmatic policy continuity (perhaps the single most tonic feature in a country whose modern history is characterized by a jarring series of policy zigzags), Peru has been among the region's top economic performers over the past 8 years. In 2008, before the international financial crisis struck, Peru's growth reached Asian tiger levels, surpassing

9%. Peru's relative non-exposure to the kinds of toxic assets that devastated the U.S. and other developed economies, the significant reserves it accumulated during the boom years, and its ability to stimulate the economy with a counter-cyclical injection of nearly USD 3.3 billion (2.5% of its GDP) enabled Peru to weather the global economic storm in impressive shape. Growth estimates for 2009 hover between 1-2%, and most analysts believe Peru is now poised to resume the strong growth trajectory it enjoyed prior to the crisis.

¶16. (C) Importantly, Peru's economic success has clearly reduced poverty levels and improved lives. According to government statistics, poverty levels plummeted from 52% in 2004 to less than 37% in 2008, and deep poverty (defined as living on less than 1 dollar a day) dropped to below 20%. The positive economic and social trends have continued since, generating diverse employment opportunities unavailable before (for example, in the emerging agro-industrial and booming construction industries), producing pockets of new wealth (particularly in Lima and coastal cities) while also fostering a still small but expanding middle class. In this sense, Peru has been and remains a positive news story.

¶17. (C) But serious challenges remain, including the glaring fact that a country with a third of its population still mired in poverty cannot call its work done. Maintaining the policy structure that ensures continued and increasingly diversified economic growth is the top priority. Distributing the benefits of that economic growth more broadly, particularly to the country's poorest and most marginalized citizens, is crucial. But these efforts will require expanding the presence of the state (the state is virtually absent from large swaths of the country), reforming state institutions and improving public services - particularly security, education and health -- so as to bridge the politically destabilizing gap between rich and poor. While the Garcia government has made some progress on this score, including by increasing social spending and pursuing an ambitious decentralization policy that has sought to devolve decision-making, development and spending authority to regional and local governments and entities, much more remains to be done.

¶18. (C) Peru's 2011 presidential elections will be pivotal. In them, and to a lesser degree in the regional and local elections this year, Peru will likely choose between a pragmatic centrist option that maintains the current course - consolidating, diversifying and building on past gains - or veering off into another direction a la Venezuela, Bolivia and Ecuador. Many analysts believe that an additional five to ten years of macro-economic stability and steady growth are needed to ensure that Peru's pragmatic consensus gains the kind of quasi-politically impregnable permanence it enjoys in, say, Chile. Because the consensus here remains fragile and subject to disruption - the Amazon violence in which 24 police officers and 10 civilian were killed this past June is a case in point - it is safe to say that Peru is not yet out of the woods. President Garcia beat his

Venezuelan President Hugo Chavez-financed rival by a narrow margin in 2006. Most analysts believe the competition could be similarly close in 2011, with Peru's clear economic and social gains partially offset by institutional weaknesses and continuously challenged by radical actors, some of them dangerous. Moreover, as a quintessential "swing-state," broadly representative of the Andean region's complex political, social and economic realities, Peru's fate will almost certainly have consequences beyond its own borders. Its success along current lines would buttress the prospects of generally pro-U.S. regional pragmatists while its defeat or failure would strengthen the hand of the instinctively anti-U.S. populist camp.

¶9. (C) U.S.-Peru relations in recent years - bridging the Toledo and Garcia governments -- have been excellent. Given our broadly shared world view, President Garcia and other government officials have forcefully defended U.S. interests in a series of UNASUR meetings in which Venezuela and others sought to mischaracterize for political advantage our Defense Cooperation Agreement (DCA) with Colombia. The GOP has also taken the same tack on Honduras, recognizing the elections as an important step toward reconciliation. Our bilateral relationship was permanently anchored in a free trade agreement that went into force early last year -- complete with cutting edge environmental and labor components. The historically intensive nature of the bilateral relationship is rooted in long-standing counternarcotics cooperation that includes supporting Peru's efforts to expand state presence, strengthen its security forces, reduce coca cultivation, interdict drug trafficking and provide poor rural farmers with licit and economically viable alternatives. It is also buttressed by extensive people to people ties - close to one million Peruvians live in the U.S. - and by a broadly favorable popular view of the U.S., reflected in recent polling that shows President Obama as the top-rated world leader and the U.S. as Peru's best friend in the region.

¶10. (C) That said, there is a growing concern among Peruvian government leaders and opinion makers that the U.S. may be too deeply distracted by its multifarious challenges at home and elsewhere to pay due attention to its partners in South America - Peru (and Colombia) foremost among them. While our Peruvian friends are perfectly aware of the U.S.'s need to focus on first things first, the perceived neglect of our interests here has led to an occasionally expressed sentiment that we may be taking Peru's progress and partnership for granted. But Garcia is not one to whine or wallow, and this sentiment has probably sharpened the GOP's pre-existing interest in diversifying its international commercial and political relations. Peru's emerging strategic partnership with Brazil, consolidated in President Lula's late December visit to Lima, is one example. Garcia's near obsessive focus on China as representing the global future is another. Peru's imminent free trade agreement with China (its top export market) and the government's recently announced plans to acquire up to 80 Chinese-made tanks are two key components of this budding relationship. The fact is, however, Peru's primary economic, security and assistance relationship remains the U.S. for now. Your visit enables us to explore key next steps on an already significant agenda.

¶11. (U) Welcome to Peru.
MCKINLEY